

Date of Hearing: January 10, 2022

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

Autumn R. Burke, Chairwoman

AB 704 (Mayes) – As Amended January 3, 2022

Majority vote. Tax levy. Fiscal committee.

SUBJECT: Personal income taxes: deduction: qualified education loans

SUMMARY: Provides an above-the-line deduction in an amount equal to the interest paid by the taxpayer during the taxable year on a qualified education loan. Specifically, **this bill:**

- 1) Provides, for taxable years beginning on or after January 1, 2023, and before January 1, 2028, an above-the-line deduction, in an amount equal to the interest paid by the taxpayer during the taxable year on a "qualified education loan."
- 2) Defines a "dependent" as the term is defined by Internal Revenue Code (IRC) Section 152, determined without regard to IRC Sections 152(b)(1), 152(b)(2), or 152(d)(1)(B).
- 3) Defines a "qualified education loan" as an indebtedness incurred by the taxpayer solely to pay for higher education expenses that are incurred on behalf of the taxpayer or the taxpayer's spouse or dependent, who is the taxpayer's spouse or dependent at the time the indebtedness is incurred. "Qualified education loan" also includes indebtedness used to refinance indebtedness that qualified as a qualified education loan.
- 4) Provides that a "qualified education loan" does not include the following:
 - a) Indebtedness owed to a person who is related, within the meaning of IRC Section 267(b) or 707(b); or,
 - b) Indebtedness owed to a person by reason of a loan under a qualified employer plan or under a contract referred to pursuant to IRC section 72(p)(5).
- 5) Defines "higher education expenses" as the expenses of attendance at an institution of higher education as provided in IRC Section 529(e)(3). "Higher education expenses" shall not include any tuition expenses in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.
- 6) Provides that any amount of interest paid by the taxpayer during the taxable year on a qualified education loan that exceeds the taxpayer's adjusted gross income may be carried over and claimed as a deduction in the following taxable year, and succeeding taxable years if necessary.
- 7) Provides that the provisions of this bill shall remain in effect only until December 1, 2028, and as of that date are repealed.

- 8) Makes findings and declarations in compliance with Revenue and Taxation Code (R&TC) Section 41.
- 9) Takes effect immediately as a tax levy.

EXISTING FEDERAL LAW:

- 1) Excludes from a taxpayer's gross income payments received by the taxpayer from their employer, up to \$5,250, for tuition, fees, books, supplies, and equipment under the employer's educational assistance program.
- 2) Excludes payments made by an employer, whether paid to the employee or to a lender, of principal or interest on any qualified education loan incurred by the employee for education of the employee. The exclusion applies to payments made prior to January 1, 2026.
- 3) Allows a deduction in computing adjusted gross income (AGI) for interest paid during the taxable year on a qualified education loan. The amount of the student loan interest deduction begins at \$2,500 and reduces gradually as the taxpayer's modified AGI increases. The deduction phases out for individuals with modified AGI above certain levels.

EXISTING STATE LAW:

- 1) Provides, under federal and state law, an above-the-line deduction for interest due and paid on qualified education loans up to a maximum of \$2,500. The deduction phases out for individuals with modified AGI above certain levels.
- 2) Provides various tax credits designed to provide tax relief for taxpayers who incur certain expenses or to influence taxpayers' behavior.
- 3) Conforms, in general, to the exclusion of up to \$5,250 of employer-provided educational assistance benefits from an employee's gross income. State law does not conform to the exclusion of payments made by employers of principal or interest on qualified educational loans that were incurred by the employee.

FISCAL EFFECT: The Franchise Tax Board (FTB) estimate a General Fund revenue loss of \$20 million in fiscal year (FY) 2021-22, \$37 million in FY 2022-23, and \$40 million in FY 2023-24.

COMMENTS:

- 1) The author has provided the following statement in support of this bill:

This legislation is simple, but could have a profound effect on those who utilize it. The current student loan interest deduction is capped at \$2,500 annually. AB 704 would remove this cap and allow all student loan interest to be deducted annually. California cannot forgive student loan debt, but it can make it easier on borrowers and reward them for attaining a higher degree when tax season comes around. The deduction would also be carried forward in years a borrower could not fully utilize their deduction.

- 2) Supporters state that this bill "[would expand] the student loan interest tax deduction permitted in current law beyond the existing \$2,500 cap for a specified number of years immediately following the COVID-19 pandemic. AB 704 would decrease the burden of educational debt on new graduates and enable physicians to commit to serving a higher Medi-Cal patient load, increasing access to health care for the poor and underserved."
- 3) Opponents state that, "We oppose measures that would divert funding from public education, particularly as 63 percent of California's students participate in the free and reduced lunch program due to their family's economic status. The granting of tax credits or deductions reduces revenue to the state's General Fund, which in turn reduces Proposition 98 funding that funds California's schools."
- 4) Committee Staff Comments:
 - a) *Drafting concerns*: Existing law already provides taxpayers with an above-the-line deduction for interest paid on a qualified education loan up to a maximum of \$2,500. Although not exactly the same, this bill could be construed as enacting a new above-the-line deduction for the same expense. If the author's intent is to make the existing deduction more generous by eliminating the cap or by eliminating the phase-outs under existing law, the author may wish to modify state conformity to federal law instead of creating a new deduction. Alternatively, this bill could clarify that the above deduction modifies state conformity to IRC Section 62(17). Committee staff is available for technical assistance.
 - b) *What is a "tax expenditure"?* Existing law provides various credits, deductions, exclusions, and exemptions for particular taxpayer groups. In the late 1960s, United States Treasury officials began arguing that these features of the tax law should be referred to as "expenditures" since they are generally enacted to accomplish some governmental purpose and there is a determinable cost associated with each of them (in the form of forgone revenues). This bill would enact a new tax expenditure program in the form of an above-the-line deduction for interest paid on an educational loan.
 - c) *Committee's tax expenditure policy*: SB 1335 (Leno), Chapter 845, Statutes of 2014, added R&TC Section 41, which recognized that the Legislature should apply the same level of review used for government spending programs to tax credits introduced on or after January 1, 2015. AB 263 (Burke), Chapter 743, Statutes of 2019, extended the requirements in R&TC Section 41 to all tax expenditure measures under the PIT Law, the CT Law, and the Sales and Use Tax Law introduced on or after January 1, 2020. A tax expenditure proposal must outline specific goals, purposes, and objectives that the tax expenditure will achieve, along with detailed performance indicators for the Legislature to use when measuring whether the tax expenditure meets those stated goals, purposes, and objectives. In addition to the R&TC Section 41 requirements, this Committee's policy also requires that all tax expenditure proposals contain an appropriate sunset provision to be eligible for a vote¹. Sunsets are required because eliminating a tax expenditure generally requires a 2/3rd vote. These requirements must be satisfied before a

¹ An "appropriate sunset provision" shall mean five years, except in the case of a tax expenditure measure providing relief to California veterans, in which case "appropriate sunset provision" shall mean 10 years.

bill can receive a vote in this Committee. This bill contains a five-year sunset and complies with Section 41.

- d) *FTB analysis*: In an analysis of this bill, the FTB outlines a number of considerations. Regarding implementation, the FTB notes this bill would remove the \$2,500 cap on the federal deduction and exclude elementary and secondary education expenses, thereby increasing the complexity of state tax return preparation.

Additionally, this bill allows for an unlimited carryover period, requiring the FTB to retain the carryover on tax forms indefinitely. According to the FTB, credits are generally enacted with a limited carryover as they are typically exhausted within eight years of being earned.

- e) *Committee amendments*: The author and Committee may wish to consider striking the contents of this bill and instead providing that the deduction authorized under IRC Section 221(a), pertaining to the education loan interest deduction, is modified by:
- i) Removing the maximum limit stipulated in IRC Section 221(b)(1); and,
 - ii) Limiting the definition of "higher education expenses" to exclude expenses related to elementary or secondary public, private, or religious school.

REGISTERED SUPPORT / OPPOSITION:

Support

California Dental Association
California Medical Association
Howard Jarvis Taxpayers Association

Opposition

California School Boards Association

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